OUR GOLD RESERVES AFTER THE WAR

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In these modern times the relationship of values the world around is in terms of gold. The standard of value, outside of China and a few unimportant countries, is gold, and local currencies are based upon gold. Even where the domestic currencies are temporarily of paper the relationship of this paper to gold is reckoned upon in all business transactions with the outside world. As soon as the war is over all countries involved in it which have ambitions in foreign trade may be expected to bring the relationship between their paper currencies and gold back to normal at the earliest possible date, by reducing the issues of paper money and by increasing their reserve of the standard metal. Fluctuations in the value of a domestic currency will be an element of uncertainty, and therefore, a handicap, in all business transactions with other countries.

With the domestic currency based upon gold reserves, it is obvious that the entire credit system of each country is based upon those reserves. Bank deposits, bank loans, commercial credits and obligations of every character rest at last upon the gold reserves, and there must be some reasonable relationship between the volume of current credit and the available stock of gold.

The Great Significance of Gold

Gold is the form of property by which the balances accruing in the trade and financial relations of nations are finally settled, and the effect of a flow of gold from one country to another has become familiar to all students of finance. When the balance of payments is against a country and gold leaves it in settlement, the effect is to reduce the base or foundation upon which the structure of credit in that country rests, and prudence requires that the volume of credit be accordingly reduced or held in check. Small movements of gold, evidently due to seasonal states of trade or other temporary conditions, may be negligible, but an outflow of gold exceeding normal proportions will receive the careful attention of financiers and busi-

ness men. It is symptomatic of unhealthy conditions. It may be that trade has lost its natural balance, that exports are falling off or imports increasing in an abnormal degree; or it may be that the securities of that country are being sent home, either because they have lost favor abroad or because other countries have an emergency need for gold to support their own credit. In any event, if gold is steadily exported from a country there must be, eventually, a curtailment of credit in that country, and higher interest charges as a result. On the other hand, a country which is receiving additions to its gold reserves is in position to enlarge its fabric of credit, and that usually results. With increasing reserves the banks lower interest rates, and encourage borrowers. Enterprise is stimulated, new undertakings are begun, labor and materials are in demand and what is known as a period of expansion is thus inaugurated as a direct result of the inflow of gold.

These conditions react from one country to another, and tend in normal times to maintain an international equilibrium. Thus, in a country which is receiving gold there will be a stimulus to industrial expansion, increased consumption of goods and materials and higher prices, while in the country which is losing gold there is an influence for the curtailment of consumption and for lower prices. The former country will naturally import more and export less, while in the latter country, these tendencies will be reversed, until the gold movement turns over and flows the other way.

CONTROLLING GOLD MOVEMENT THROUGH THE DISCOUNT RATE

All phases of this subject have been long under observation abroad, and particularly in London, which has been for many years the most important international money-market. The Bank of England, as the custodian of the gold reserve of that market, has had more experience with this problem than any other institution, and long ago developed a scientific policy of action now confirmed and adopted by financial authorities generally. It has been demonstrated that under ordinary conditions the gold reserve can be controlled by the discount rate. A rising rate has a tendency to curtail borrowing, and bring about a reduction of loans, with the result that money is paid into the bank on balance. On the other hand, lowering the discount rate encourages borrowing which increases deposits and lowers the reserve percentage even though the reserves are not

actually reduced. There is likely, however, to be a double effect, for when the borrowed credit is drawn upon the bank will probably lose money on balance.

It will be seen that an intelligent control of the discount rate accomplishes the same result that is eventually worked out blindly if no management of the gold movement is attempted. If the central banking institution permits a growing inflation of credit and a loss of reserves, that movement will go on until a crisis is reached, when the bank, having reached the limit of prudence, will be forced to suddenly raise its discount rate or refuse discounts entirely. This action taken abruptly gives a shock to credit and may precipitate a panic. It happened repeatedly in the history of the Bank of England until gradually the policy of foresight and control was adopted. As credits expanded, or reserves diminished, the bank raised the discount rate, thus discouraging the tendency and keeping the situation in hand. In short, instead of having changes in the discount rate follow the inflation of credit and loss of reserves as a result, the latter-day policy makes use of the discount rate, to guide the money-market, check undue inflation and prevent loss of reserves.

The Bank of England's Use of the Discount Rate

The principles involved in the use of the discount rate were strikingly illustrated in the policy of the Bank of England in 1907, when a banking panic prevailed in the United States. The banking system of the United States at that time was without means of meeting a sudden and general demand for cash, except by importing gold. The interior banks drew heavily upon New York and other financial centers, and the banks at these centers made every effort to procure gold abroad, and particularly from London. Our grain, cotton, meats and other products were exported as rapidly as possible, our securities which had standing in foreign markets were sold at bargain prices, and our credit was used freely for short loans. We were literally buying gold as a manufacturer might buy coal in a time of fuel famine to keep his factory running. We imported about $100,000,000 of gold in two months, and four-fifths of it came from the Bank of England. It was impossible for the bank to stop the flow by any ordinary means. It raised the rate of discount to 7 per cent without affecting the outward movement to the United States, because the inducements offered here far outweighed that unusual

charge. But while the rate did not stop the outward flow, it started an inward flow to the bank which practically offset the former movement. The people who wanted to pick up bargains in the United States continued to borrow, but other people who had no relations with the United States, and who did not care to speculate in a time of alarm, were influenced by the high rate to pay their obligations at the bank as fast as they could do so. Ordinary business was curtailed, men refrained from purchases and investments which they otherwise would have made, and postponed new enterprises to more auspicious times. Money flowed into the bank from the provinces in payment of loans, and, what was more important, from all over Europe. London is a great money market; people go there from all parts of the world, both to lend and borrow. When its bank rate went up to 7 per cent the borrowers upon the continent and in other quarters hustled about at home and raised money to pay off London, while at the same time lenders hurried money to London to take advantage of the high rate. And so it came about that when the stress was over, and after London had shipped $85,000,000 of gold to New York, the Bank of England had a higher percentage of gold reserve than when the movement began.

CONTROL THROUGH A PREMIUM UPON GOLD

Such is the recognized importance of the discount rate as a means of controlling the movements of gold, that the Bank of England frequently enters the London money-market as a borrower, competing with the public, in order to raise the outside rate to the level of the bank rate, thus getting the influence of the entire market against a further expansion of credit, with consequent withdrawals of gold.

The discount rate is not the only means adopted to discourage withdrawals of gold. The Bank of France has followed the policy of charging a premium upon gold. Under the old bimetallic system which is still maintained in France, except that the coinage of full-tender pieces has been discontinued, the five franc pieces are still a legal tender, and the bank has the option of paying its obligations in silver. If it desires to discourage the exportation of gold, it exercises this option or imposes a small charge upon gold. This charge has the effect of an ad valorem tariff upon importations, and affects all foreign payments in like manner. The effect is less objectionable in France than it would be if France were not a creditor country.

Foreign capital is seldom employed in France, and therefore, has not been called upon to pay this premium, but the charge has probably operated to the advantage of London and the prejudice of Paris, as a world's money market. Gold will not flow freely to any market from which it cannot be withdrawn with equal freedom.

LACK OF CONTROL IN THE UNITED STATES

In years past there has been little appreciation in the United States of the importance of having a banking organization able to cope with this complex problem of the exchanges. We have had a thoroughly decentralized banking system, composed of a great number of independent institutions, organized under different state laws as well as under the national act. There has been no definite responsibility anywhere for the regulation of the interest rate, or for the supply of gold required in the settlement of foreign balances. By reason of being located at the chief port and financial center, the New York banks have had the most intimate relations to the problem, but the competitive conditions existing between New York and other important cities, and between national banks, state banks and trust companies in New York, and the absence of any special powers for dealing with the problems, have all hampered the ability of the New York banks to deal with the situation. As a result there has been but little of that management or control which the Bank of England, and the other central banks of Europe, have continually exercised over the exchanges. We have drifted, and suffered from the extremes of unregulated credit—expansion and the ebb and flow of gold, just as other countries suffered before they learned the secret of control by means of the discount rate. In a period of prosperity there was no responsible authority to utter a warning or to set a limit upon the expansion of credit, and expansion usually went on until the structure became top-heavy, and then an outward movement of gold set in and weakened the foundation until a collapse resulted, followed by a period of depression.

There were always bankers and economists in the United States who understood the weakness of our banking situation, but they were without sufficient influence to change it. In fact it has never been considered the proper thing in the United States to take the advice of bankers about banking legislation. Finally, however, the

panic of 1907 aroused a general public interest in the subject, and the work of the National Monetary Commission in its foreign inquiry made the country fairly well familiar with the fundamental principles which had been demonstrated.

The result was the establishment of the federal reserve system in which all national banks and a few state institutions are included. This gives an organization and cohesion to our banking system which was lacking before. Final reserves have been set aside which are made available to the member banks by means of rediscounts, and the rate for these rediscounts is under the control of the Federal Reserve Board. Although the system of twelve reserve banks is unusual and complex, the principle sought to be put into effect is the same as we see demonstrated in Europe. This system depends for its effectiveness upon the authority and attitude of the Federal Reserve Board. The sense of responsibility to the whole country will be hard to maintain in twelve individual institutions. There is danger that the local or district view will become habitual with the managements, that they will tend to forget their relationship to the system, and that, isolated as it is from actual operations, the Board at Washington may relax its control over them. The burden of dealing with the foreign exchanges, and of supplying gold for the settlement of foreign balances, will fall almost entirely upon the New York bank, but the balances themselves will be for account of the whole country, and the policies for controlling the situation must be participated in by all the banks. It remains to be seen whether this relationship is clearly comprehended, and whether each of the twelve institutions will readily make the sacrifice of revenues to itself, and the curtailment of accommodations to its locality, which at times will be necessary if the system is to do its work effectively. The New York bank has been limited in territory to New York state and small sections of Connecticut and New Jersey for its resources, but it must handle the international relations of the United States.

OUR PRESENT ACTIVITY ABNORMAL

The Federal Reserve Board's control of rediscount rates, if effectively used, will do much to prevent the undue expansion of credit which usually precedes and promotes an outward movement of gold. But the exportation of gold may result from other causes. The great industrial activity which now exists in the United States

is not due to credit expansion, although there is constant danger that undue credit expansion may result from it. Conditions outside of ourselves are responsible for this activity. An abnormal and temporary foreign demand is driving our industries to their capacity, and a great trade balance in our favor is pouring hundreds of millions of gold into our vaults. This influx of gold and imperative demand for our products is radically affecting industrial conditions in this country in a manner unfavorable to our trade position after the war. In normal times a state of unusual industrial activity here will bring hundreds of thousands of laborers from abroad. The productive capacity of the country is thus increased and the effect of the unusual demand for labor is diffused abroad as well as at home. But at this time little or no new labor can be had from abroad, and the efforts to put this additional amount of capital into use are expended upon the existing labor supply. That supply being limited, and the amount of capital seeking to use labor rapidly increasing, the result is that industries are bidding against industries, and employers against employers, and wages are advancing to unheard of figures.

We have had boom periods in the United States before, but never one when conditions were so abnormal as now. We are perfectly aware that they are abnormal, and cannot be maintained when the war is over, and yet we are daily creating new relationships upon this basis which cannot be readily changed. We know that when all the men engaged in war and upon war work go back to producing peace products the prices of all such goods will fall, and the entire fabric of costs will have to be made over. Experience teaches that costs can only be reorganized on a lower basis under pressure, the pressure of competitors who are taking the market. We have to expect, therefore, after the war that we will be undersold not only abroad but at home and that a balance of trade upon merchandise account will be created against us. If it is not so it will be because we show a facility in readjustment which no people have ever shown before, and the only hope of this lies in sounding the warning continuously.

Foreign Demands for Our Gold

Furthermore, at the end of the war there will be pressing need for capital in all the countries that have gone through the strain of war, and for gold for use as the basis of credit. Every practicable

effort will be made to attract gold. If present efforts to induce the holders of American securities to part with them do not clear the strong boxes, further efforts may then be made. Moreover, our government is giving assistance, by making our income taxes apply to the foreign holders of our securities, something we have never done in the past. At present rates of taxation everywhere few people will care to be subject to taxes under two governments.

There has never been a heavy movement of gold to this country that was not followed by a return movement, and it cannot be expected that this extraordinary occasion will prove an exception. The United States is acquiring far more than its share of the world's gold, measured by any standard of distribution that has been known in the past.

HOW TO CONTROL GOLD EXPORTS

When the return movement appears there will be means of mitigating its force, in the foreign loans that have been placed in this country. These obligations of foreign governments, banks, corporations and individuals, falling due in one and two years as they mature, will count in our favor as so much gold. Evidently they can be allowed to run off with less disturbance than would follow the withdrawal of gold from our bank reserves after it has been made the basis of domestic credit. These foreign loans will be our first line of defence, and they will be an important bulwark. After them will come the gold holdings of the Federal Reserve Bank of New York, and as these shrink, the supreme test of the federal reserve system will come. Will it meet the crisis as twelve banks, or as one organization? The Federal Reserve Board has authority to call upon the other reserve banks to rediscount paper for the New York banks, which would effect a transfer of gold, and there is every reason to believe that the Board as now constituted, will direct this to be done.

Even so, however, the available gold resources of the system are not what they should be. The total stock of gold in the country is approximately $2,550,000,000, but the holdings of the twelve reserve banks are only $536,000,000. The United States Treasury holds $1,466,000,000 of gold against which certificates for an equal amount are outstanding. Excepting what is in the federal reserve banks, and the banks of the central cities, this gold is practically out of reach. It is a part of our wealth but it does not serve the purpose

of a gold reserve. The efficiency of gold is largely lost when it is used as ordinary till money, or carried about in the pockets of the people.

INFLUENCE OF THE FEDERAL RESERVE SYSTEM

The Federal Reserve Board made an effort at the last session of Congress to obtain greater freedom for the reserve banks in acquiring gold, and its recommendations were logical and apparently conclusive, but timidity and a mistaken conservatism defeated the proposals. The system will not be as strong as it should be, to support the business interests of the United States, until means are adopted to place a larger proportion of the gold stock of the country where it is available for use in time of need.

There has been some ill-advised criticism of the reserve banks for not having made a better showing in the matter of earnings. So far as this criticism is directed at the costly policy of creating twelve banks when one-half that number would have answered the essential purposes of this system, there is a basis for them, but it must be borne in mind that when these banks extend themselves freely in normal times they lose the power to control the situation when a crisis comes, and this is the occasion for which they were created.

Outside of the foreign loans now being made in the United States we have no body of foreign indebtedness here upon which our domestic interest rates can be made effective in a crisis. We cannot, therefore, expect the discount rates of our federal reserve banks to have the same influence upon an outward gold movement as the Bank of England is able to exert in the London market. Our rates can be effective only upon our own borrowings, and in keeping down the volume of credits which may be based upon this stock of gold upon which we have but a precarious hold. As yet the rates of the reserve banks have been scarcely a factor in the market, owing to the abundance of cheap money, but their function is not to make credit cheap, but to keep credit in reserve and have on hand a stock of gold which can be released for export with a minimum disturbance to credit conditions in this country.